

1999

## Annual report 1999

American Institute of Certified Public Accountants. SEC Practice Section. Public Oversight Board

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PUBLIC  
OVERSIGHT  
BOARD

Annual  
Report  
1999



## With Gratitude

*In January 2000, A. A. Sommer, Jr. retired as a member of the Public Oversight Board. Mr. Sommer joined the Board in 1983 and served as its Chairman from 1986 to 1999.*

*Long recognized as a pioneer in corporate governance and financial reporting issues, Mr. Sommer was a Commissioner of the U.S. Securities and Exchange Commission from 1973 to 1976. He is presently of Counsel to Morgan, Lewis & Bockius LLP, Washington, DC, and was a partner of the firm from 1979 to 1994.*

*Reflecting on Mr. Sommer's contributions, Melvin R. Laird, himself a Board member since 1984 and former nine-term U.S. Congressman and Secretary of Defense, observed: "During Al's tenure on the Board, which coincided with a difficult period in the accounting profession, he inspired his fellow Board members and the whole profession with his leadership. He approached each challenge logically, calmly, cheerfully and with full knowledge of the issues and he always articulated reasonable solutions to difficult issues."*

*Mr. Robert Elliott, AICPA Chair, on the occasion of honoring Mr. Sommer's retirement observed: "Al's biggest contribution derives from his commitment to the public interest and his power to reason. There was never a time when he did not have the public interest in mind. Every person in dialog with Al knew that. And every person in dialog with Al would have an opportunity to get his or her assumptions subjected to a wonderfully inquiring mind, a mind conversant with the fundamentals of the public disclosure system as few ever have been."*

*The Board is deeply appreciative of Mr. Sommer's wisdom and leadership in meeting our public responsibilities.*

## Panel on Audit Effectiveness

The Panel's primary purpose is to examine whether the audit processes of large-firm members of the SEC Practice Section (SECPS or Section) adequately serve and protect the interests of investors. The Panel's project encompassed making a comprehensive review and evaluation of the way independent audits are performed and assessing the effects of recent trends in auditing on the public interest.

The Panel spent most of 1999 collecting information (i.e., the "data gathering phase"). The Panel's project is the largest, most expensive research project/data gathering exercise ever undertaken in the accounting profession.

The Panel's major effort was the review of the audits of 130 SEC registrants in 28 offices of the eight largest CPA firms. These engagements were selected on the basis of risk profiles established by the Panel for the purposes of:

- Assessing the quality of the audit work performed in specific key areas.
- Assessing whether the individuals who performed and reviewed the work have the necessary knowledge, skills, and experience.
- Assessing whether the work was performed appropriately and reviewed on a timely basis.
- Developing ideas for enhancing audit effectiveness.

In addition to reviewing audit engagements, in-depth interviews were conducted with the partner in charge of the office's audit practice and those who assist him, e.g., in recruiting and scheduling, and two focus groups—one with five to eight senior auditors who work on audits of public companies, and the second with five to eight audit managers or senior managers.

The Quasi Peer Reviews (QPRs) differed in many respects from SECPS peer reviews; e.g., the engagement reviews included more interviews with the engagement personnel; the reviews were limited to certain specific areas of the audit, such as the risk assessments, the linkage of the risk assessments to the tests of controls and substantive tests, and the substantive tests in certain areas; and no reports or letters of comments were issued. However, in the areas reviewed, the reviews were more in-depth and subjective.

Overall the results of the QPRs were quite favorable; e.g., the risk assessments generally were made by the right people, the appropriate audit procedures were performed, and any audit differences were resolved appropriately. However, the reviews indicated certain areas of audit performance that will result in the Panel making a number of recommendations to the Auditing Standards Board, the firms, the SECPS Peer Review Committee, and the POB regarding improving audit effectiveness.

The Panel's initiatives are set forth in Table I.

The Panel is presently developing its recommendations and drafting an Exposure Draft of its report which will include recommendations specifically

designed to improve the way audits are performed. The Panel hopes to issue the Exposure Draft in early spring, hold public hearings soon thereafter to hear constituents' comments, and issue a final report before summer.

TABLE I – PANEL'S 1999 INITIATIVES

■	<i>Review of audit engagements of eight largest CPA firms.</i>
■	<i>Holding two days of public hearings at which 21 organizations were represented, including the SEC, auditors, preparers, analysts, plaintiffs' and defendants' bar, standard setters, and educators.</i>
■	<i>Sending a broad questionnaire, "Request for Opinions on Issues of Audit Effectiveness Addressed to Thought Leaders and Key Stakeholders," to over 500 selected individuals and organizations representing a wide range of constituencies. The Panel received and analyzed approximately 90 responses.</i>
■	<i>Holding 11 focus groups—one with CFOs and controllers, one with internal auditors, one with individuals who perform peer reviews of smaller firms, and eight with representatives of the eight largest firms—each of these eight focus groups included one representative from each of the firms. One of the focus groups consisted of partners, three of managers, three of seniors, and one of staff personnel below senior. A professional facilitator conducted all the focus groups except the one with the individuals who perform peer reviews of smaller firms.</i>
■	<i>In-depth interviews of audit personnel.</i>
■	<i>Holding two meetings early in the project with the accounting and auditing leaders of each of the eight largest firms to gain an understanding of their audit methodologies and of their views regarding the environment in which audits are being performed and the key issues the Panel should consider.</i>
■	<i>Reviewing the eight largest firms' audit policies and procedures and guidance materials, as well as information about their risk management and professional development activities, policies and procedures for recruiting, evaluating, compensating, and promoting audit personnel, and audit-related marketing publications.</i>
■	<i>Holding numerous meetings with representatives of the SEC and various private-sector bodies involved in the governance of the profession, such as the SECPS Executive, Peer Review, and Quality Control Inquiry Committees and the POB. Generally, the Panel Chairman or the Staff Director or other members of the staff represented the Panel at these meetings.</i>
■	<i>Conducting research, with the assistance of the SEC staff, into the causes and circumstances that led to recent SEC Accounting and Auditing Enforcement Releases against the eight largest firms and/or their clients.</i>
■	<i>Holding six Panel meetings lasting eight days in total.</i>

# Auditor Independence

## Background

On November 30, 1998, Lynn Turner, the SEC Chief Accountant, wrote to SECPS Executive Committee Chair Michael Conway, expressing the SEC staff's concerns about auditor independence-related matters. He indicated that the number of instances of independence problems observed by his staff suggests that quality control systems "have not been sufficient to identify and preclude significant independence problems from arising." These problems, he reported, are in "areas as basic as ownership of stock in audit clients." His letter indicated there are also other areas for concern, e.g., the performance of a wide array of non-audit services by foreign affiliates of member firms who may not be familiar with U.S. independence requirements.

On December 30, 1998, the Executive Committee Chair wrote to the managing partners of the firms in the Section and urged all the firms in the Section to heighten their awareness of independence matters.

On January 14, 1999, the SEC settled charges against PricewaterhouseCoopers LLP (PwC) for engaging in improper professional conduct by violating SEC auditor independence rules. In more than seventy instances, some partners and managers, or its pension fund, had purchased securities of audit clients. PwC agreed, among other things, to improve its internal procedures for monitoring adherence to auditor independence rules, and to conduct an internal investigation supervised by an outside person named by the SEC. Among other procedures, PwC agreed to implement "investment tracking procedures," e.g., establish and maintain a database of its publicly held audit clients and of the transactions of its partners, and to compare each security transaction by a partner with that database and take action if a partner invests in the securities of a publicly held audit client. In addition, PwC

agreed to report to the SEC any additional instances identified in the internal investigation where a partner or professional staff owned the securities of a client in contravention of independence standards and SEC regulations.

On January 6, 2000 the staff of the SEC made public the report of the independent consultant who was appointed by the Commission in March 1999 to conduct a review of possible independence rule violations by PwC arising from ownership of client-issued securities pursuant to the settlement of the January 14, 1999 enforcement action referred to above. That review disclosed that a substantial number of PwC professionals, particularly partners, had violations of the independence rules (1885 professionals had a total of 8064 infractions over a two-year period, involving 2159 clients).

In October 1999 the Section adopted new membership requirements concerning the quality control systems of member firms in the area of independence. The requirements

TABLE II – SECPS YEAR 1999 INDEPENDENCE  
MEMBERSHIP REQUIREMENTS

- *The establishment of independence policies available to each professional.*
- *Independence training at time of employment and periodically thereafter.*
- *Maintenance of a database of restricted entities.*
- *Management of oversight of independence matters and procedures to follow-up on violations.*
- *Review of the restricted entity list by each professional prior to acquiring a security, obtaining a loan, opening/modifying a brokerage account or entering into business relationships.*
- *Confirmation by each professional of compliance near the time of employment and annually thereafter.*
- *Reporting by each professional of apparent violations and the related corrective action to be taken.*

became effective January 1, 2000, with the exception of provisions relating to training which will become effective no later than December 31, 2000. See Table II.

The Executive Committee chair in transmitting the new requirements in October 1999 to all SECPS firms informed them that a SECPS task force will continue to review independence related developments as they arise and will propose further revisions if warranted, including the possibility of requiring some or all firms to establish “investment tracking” systems.

### Current Initiatives

In separate letters dated December 9, 1999 to the SECPS and the POB, the Chief Accountant of the SEC urged both the Section and the POB to undertake strong initiatives to avoid serious deterioration in “public confidence in the current self-regulatory process and its dependence on internal controls of member firms and external peer review.” He urged quick action on the part of the Section to undertake

several initiatives, which are discussed below, that would strengthen the way firms monitor compliance with the profession’s independence standards, and asked that “the POB oversee the actions of the SECPS in responding to these concerns” and strongly recommended that “the POB undertake a special review of SECPS member firms’ current compliance with SEC and profession independence rules.”

In a December 21, 1999 letter to the Chief Accountant, the POB agreed to develop a work program, and identify the legal and auditing resources necessary to conduct oversight of the Section’s independence related initiatives and to conduct a special review of member firms’ compliance with the profession’s and the SEC’s independence rules.

The SECPS Executive Committee at its January 2000 meeting adopted an action plan to establish requirements for the implementation of mandatory additional quality control measures to enhance compliance with existing independence rules. The action plan is

based on the further work of its task force referred to above, and is in response to the SEC’s letter of December 9, 1999. Key features of the SECPS action plan are set forth in Table III.

The POB is presently developing a work plan to provide assurance about the design and implementation of these additional quality control measures.

The Board, as an interim measure, has inserted a notification in the public file of all SECPS member firms. This letter refers to the Chief Accountant’s December 9, 1999 letter to the Section which questions the sufficiency of worldwide quality controls over independence and calls upon the Section to adopt revised membership requirements by March 31, 2000 that would cause the member firms to implement enhanced quality controls by January 1, 2001. It notes that the peer reviews that have been accepted by the Section relate to systems that have not been enhanced and were “conducted following existing peer review standards, under the oversight of the POB, and have not been adjusted to include additional tests that may be required in the future.”

**TABLE III – KEY FEATURES OF SECPS YEAR 2000  
AUDITOR INDEPENDENCE INITIATIVES**

- *Automated real-time systems for the five largest firms that will produce electronic listings of restricted entities and track the investments of all U.S.-based partners and managers to ensure violations are avoided or, if they occur, are quickly discovered and resolved.*
- *Enhanced “plain English” policy guidance for all professionals that explains in understandable terms the many complexities of existing independence rules.*
- *Improved internal compliance testing programs, including ongoing internal auditing within each firm as to the completeness, accuracy and timeliness of partner and manager reporting of all of their investments and those of their spouses, cohabitants and dependents.*
- *Internal disciplinary processes and specific sanctions for independence violations.*
- *A comprehensive training course that all professionals are required to complete.*

# POB Meeting Report

The Board held seven regularly scheduled meetings and two special meetings during the year ended December 31, 1999. At one or more of these meetings, the Board held discussions about the SECPS self-regulatory programs and other matters relating to audit effectiveness with the chair and staff director of the Panel on Audit Effectiveness, the Chief Accountant of the SEC, the chair of the SECPS Executive Committee, the president of the American Institute of CPAs, a member of the Panel on Audit Effectiveness, the chair of the task forces dealing with Re-evaluation of the Peer Review Process and International Quality Control, and the former chair of the Financial Accounting Standards Board.

The Board also conducted an educational session on the POB's oversight role for the Panel on Audit Effectiveness and met with the Panel in November 1999 to discuss matters related to the Panel's work.

The Board's Vice Chair testified in December 1998 at the public hearing of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.

The Board's Chairman met with the chairman of each of the largest five CPA firms to discuss issues relating to the effectiveness of self-regulation and the role of the POB. Board members and staff met on a number of occasions with the Chairman and Chief Accountant of the SEC. A Board member and staff attended all meetings of the Independence Standards Board.

Board members and staff participated in the deliberations of the SECPS task forces on Peer Review Process, Quality Control Inquiry Process, Concurring Partner Review, International Quality Controls Issues, Independence and Quality Controls and Alternative Practice Structures. The staff also participated in meetings with representatives of the accounting profession of Germany, the Netherlands and Saudi Arabia to explain the U.S. self-regulatory programs.



## SECPS Executive Committee

*The Executive Committee is responsible for all the self-regulatory activities of the SEC Practice Section and for setting membership requirements for member firms. Membership requirements, such as concurring partner preissuance review of SEC registrant audits, are intended to enhance the quality of audit practice before the SEC.*

A Board member and staff attend each meeting of the SECPS Executive Committee and its Planning Committee and participate as appropriate. The Committee adopted a number of important new membership requirements, which are described below. In addition, the Committee's Professional Issues Task Force (PITF) has issued two Practice Alerts this year which are available on the AICPA web site.

*Guidance for Independence Discussions with Audit Committees and How the Use of a Service Organization Affects Internal Control Considerations.* Another Alert, *Accounting for Certain Equity Transactions*, was released in January 2000. The Board's staff participates in PITF meetings to assist in the accumulation and consideration of practice issues for publication in Practice Alerts to practitioners.

### Concurring Partner Review.

Last year the Eighth Circuit Court of Appeals upheld the decision handed down by an administrative law judge in a SEC proceeding which expanded the responsibility of the concurring review partner.

A revised requirement effective October 1, 1999 was adopted by the Section. The new membership requirement acknowledges that "the concurring

partner review is an integral part of the firm's system of quality control." The objective of the concurring partner review is review of (a) significant auditing, accounting, and financial reporting matters that come to the attention of the concurring partner reviewer and (b) the resolution of such matters prior to the issuance of the firm's audit report. The review should result in the conclusion that nothing has come to the concurring review partner's attention to suggest that the financial statements do not conform to generally accepted accounting principles or that the audit was not conducted in accordance with generally accepted auditing standards. The requirement now specifies six procedures that the review partner should perform to fulfill this assigned responsibility. And it proscribes the engagement partner from serving as concurring partner reviewer for at least two audits subsequent to service as engagement partner.

### International Quality Control.

The self-regulatory programs of the SECPS do not include foreign affiliates and components of U.S. member firms. Furthermore, international accounting firms vary in the degree of autonomy of their foreign affiliates and no foreign jurisdictions have a peer review program comparable in scope to that of the SECPS. To assist in providing assur-

ance about the adherence to U.S. accounting and auditing requirements in the existing environment, the Section adopted a new membership requirement that addresses international filings in the U. S. securities markets that involve the foreign affiliates and components of SECPS member firms.

The requirement specifies certain procedures that should be performed and documented by a "filing reviewer" knowledgeable in U.S. accounting and auditing standards, SEC requirements, and independence standards to assist foreign associated firms in complying with U.S. professional standards. The requirement also calls for the internal inspection of a sample of audits of foreign registrants performed by the foreign associated firm. This review requires a determination that nothing has come to the inspector's attention to cause the belief that the audit or reporting was substandard or that the specified procedures called for by the membership requirement had not been performed.

Under the membership requirement, SECPS firms that are members of, correspondents with, or similarly associated with international firms or associations are required to seek adoption of the procedures referred to above by the international organization. They are required to report annually to the SECPS on which foreign affiliated firms have adopted such policies.

The SEC staff has agreed to change the process it now uses to qualify foreign firms that practice before the SEC to give recognition to the foreign firms that have adopted the quality control procedures required by the new membership requirement. The SECPS membership requirement is effective January 1, 2000.

## Re-evaluation of the Peer Review Process.

During 1999 the Section completed a re-evaluation of its peer review program. The four areas reviewed were Process, Reporting, Governance and Oversight, and Qualifications and Training of Reviewers.

Process recommendations include an annual limited review to be performed on large firms in addition to the triennial peer review. Such limited reviews should include at least the following:

- Follow-up on actions taken to deal with the last peer review letter of comments, *summary observations memorandum* (see below), and *recommendations letter* (letter detailing observations and recommendations from the limited review).
- Review of changes to implement significant new professional standards.
- Determine whether the firm's internal inspection program adequately considered emerging issues and higher risk areas and the firm has taken appropriate actions with respect to any engagements with material findings.
- Preparation of a recommendations letter.

Reporting recommendations include the preparation on each review of a *Summary Observations Memorandum*. This document will describe the reviewer's observations regarding best practices and constructive suggestions that go beyond professional standards.

Governance and oversight recommendations include the PRC's preparation of an annual report for the profession, standard setters, regulators and others

that describes significant matters noted during peer reviews conducted during the year. Also, the PRC will identify emerging issues and higher risk areas to provide more frequent updates to its peer review program.

It was also recommended that the POB expand the scope of its oversight of large firm peer reviews. Particular emphasis should be given by the Board to identify areas of high risk to be included in peer reviews.

Recommendations for qualifications and training of reviewers include a more formal system for evaluating the performance of peer review team captains.

## Alternative Firm Practice Structures.

In recent years, several multi-service financial service companies have acquired the non-attest practices of public accounting firms. This consolidation of accounting firms by "consolidators" has resulted in significant changes in the structure of firms and their systems of quality control. It is not unusual for the owners of the CPA firm whose non-attest practice has been acquired to form a new CPA firm solely to provide attest services to SEC registrant and non-public companies. The new firm leases employees, space, and equipment from the multi-service financial service acquirer for which it pays a percentage of revenues and profits.

The reasons for traditional firms to enter into such arrangements generally relate to the desire of smaller firms to remain competitive in terms of services provided to clients, and the need to have capital for investment in technologies and even to fund retirement benefits. And these motives are not confined to smaller firms.

A number of quality control issues arise from these consolidations. The most significant of which relates to independence.

On January 7, 1999, the Chief Accountant wrote Independence Standards Board (ISB) Chair William T. Allen, urging that the issue of evolving forms of practice be added to the agenda of the ISB, because they "raise very significant public policy issues." The ISB added a project to its agenda to deal with these independence issues. The ISB has issued Discussion Memorandum (DM) 99-2, *Evolving Forms of Firm Structure and Organization*, and our Board has responded to the DM. We have advised the ISB in a comment letter that, in our opinion, "public ownership in a firm performing audits or in its parent or in an entity that effectively has control of the auditing firm is not appropriate."

As a result of the lack of definitive independence standards regarding alternative firm practice structures, the Peer Review Committee is requiring that the letter of comments for every such firm include an acknowledgement that independence standards do not currently exist.

The Section is considering other quality control issues presented by non-traditional accounting firm structures, e.g., certain quality control procedures may be performed wholly or partially by the consolidator or one of its associated entities, particularly certain of the procedures relating to monitoring of independence, continuing education and the recruiting and advancement of personnel.

## Peer Review Process

*Since 1977, the peer review process has been the primary component of the profession's self-regulatory program. For over 20 years, the SECPS peer review program has provided the public and the profession with assurance that member firms have established sound quality control systems and, based on rigorous testing, has identified areas to continually improve those systems. The SEC Practice Section's Peer Review Committee oversees the peer review program, which includes virtually all firms auditing SEC registrant clients.*

### **POB Oversight of the SECPS Peer Review Process.**

For all firms with SEC registrants as clients, the Board's staff performs one of three levels of oversight, with a more intensive emphasis on those peer reviews that have a higher risk to the public interest, such as firms with a large number of SEC clients and firms with a history of performance problems, including litigation and regulatory actions.

During the 1998-99 peer review year, 418 SECPS peer reviews were performed (253 firms with SEC registrant clients and 165 firms that had no SEC clients).

The Board's staff during the year oversaw the reviews of five large accounting firms. Those reviews took place over several months and oversight included an evaluation of the scope of the review and the comprehensiveness of the review programs to be used. The staff also visited at least three practice offices during the performance of each review to observe, inquire and test the qualifications of reviewers, the scope of review, the effectiveness of the review procedures and the evaluation of the severity of deficiencies, and the candid-

ness and completeness of the communications of deficiencies to the reviewed firm and in reports to be included in the public file of the Section. A Board member attended the final exit conference of each review at which time the review findings are communicated to top management and corrective action plans are agreed to.

The Board's staff directly participated, through on site visits of 48 other firms with SEC registrant clients. All peer reviews of firms with 20 or more SEC clients, except one, were visited by POB staff during the conduct of the peer review. The staff also visited and directly participated in the reviews of 18% of the remaining firms with SEC clients, including 28% of the firms with 5 or more SEC clients. In addition, POB staff visited approximately 44% of the peer reviewed firms with SEC clients that received a modified report on their quality control systems during their prior peer review.

The POB staff reviewed the peer review reports and reviewers' working papers, discussed significant issues with the reviewers, obtained explanations and clarifications of matters regarding reviewer qualifications, scope of

review, engagement performance and peer review reporting for all other peer reviews of firms with SEC registrant clients. The staff satisfied itself that all matters were properly resolved and reported on in accordance with the peer review standards.

The evaluations task force of the Committee conducts one to two meetings per month to consider and process the reports on individual peer reviews. The POB staff participated in all such meetings and communicated all significant matters that arose during the course of the Board's oversight program.

During the year the entire Peer Review Committee met on four occasions. A Board member and the staff observed and participated in all such meetings.

### **Peer Review Committee Consideration of Reports.**

Every SECPS peer review is reviewed by the Section's Peer Review Committee. As of March 1, 2000, 3 of the 418 1998 peer reviews have not been processed because of problems encountered with the performance of team captains.

### **Peer Review Committee Monitoring of Imposed Corrective Actions.**

The Peer Review Committee evaluates each firm's peer review report to determine if the firm's self imposed corrective action plan is adequate. When the Committee concludes the actions are not adequate, the Committee requests that the reviewed firm implement specific remedial actions beyond those recommended by the peer reviewer. During the past year, reviewed firms have voluntarily agreed to all Committee requested remedial actions. Table IV summarizes the Committee-required actions.

The Committee and its staff actively monitor the timeliness and effectiveness of firms' compliance with the agreed upon corrective actions, and if appropriate measures are not taken by the firm to improve its quality control system, or compliance therewith, additional Committee actions are imposed. During the past year, firms have generally cooperated with the Committee and taken timely corrective actions to improve their systems of quality control.

#### **Communications with Standard Setters.**

The peer review process also provides a vehicle to identify areas for professional-wide improvement in professional guidance and standards. During the year, the Committee identified several emerging practice issues and areas where practitioners have had difficulty

applying the standards. These matters were communicated to either the appropriate standard setters for their evaluation and consideration or to the Professional Issues Task Force for their consideration of additional professional-wide guidance.

#### **SEC Access to the Peer Review Process.**

Since 1981, the staff of the SEC's Office of the Chief Accountant has had access to the peer review process and the POB staff's oversight thereof through a formal memorandum of understanding between the SEC, the Section, and the POB. The SEC procedures described in the memorandum were designed to enable the SEC to make its own evaluation of the adequacy of the Section's peer review program and the effectiveness of the monitoring by the POB of that program. This understanding allows the

SEC staff to have access to POB files on its oversight of individual peer reviews of firms with SEC clients and access to selected files of peer reviewers of firms that audit SEC registrants. The SEC's inspection of 1998 peer reviews is substantially complete.

#### **Summary and Conclusions.**

As in previous years, based on oversight procedures, the Board has concluded that the peer review process has contributed significantly to improvements in the quality control systems of member firms and thereby to the quality of auditing in the United States. As discussed above, the Board and its staff are closely monitoring the work of the Panel on Audit Effectiveness, and considering the implications of the auditor independence matters discussed elsewhere in this report, to assure that appropriate initiatives are underway.

**TABLE IV – MAJOR CORRECTIVE MEASURES IMPOSED BY THE  
PEER REVIEW COMMITTEE TO ENSURE THAT  
QUALITY CONTROL DEFICIENCIES ARE CORRECTED**

Action	Number of Times	
	12 Months Ended 6/30/99	Since Inception
Accelerated peer review	1	54
Employment of an outside consultant to perform preissuance reviews of financial statements or other specified procedures	11	110
Oversight by the peer reviewers or a Committee member to monitor progress made by the firm in implementing corrective actions	11	220
Oversight of the firm's internal monitoring program	32	402
Changes made in the firm's quality control document or other guidance materials	1	44
Continuing professional education in specified areas	4	62*
* Since July 1, 1988, as data for prior years is no longer available		



# Quality Control Inquiry Process

*The Quality Control Inquiry Committee, which was formed in 1979, is an important element of the accounting profession's self-regulatory program. Member firms are required to report, within thirty days of service, to the QCIC all litigation alleging deficiencies in the conduct of an audit of the financial statements of a SEC registrant and certain other entities. The QCIC's primary focus is to ascertain if the allegations in the complaints indicate a need for the named member firms to take specific corrective actions to improve their quality control systems or a need for profession-wide guidance or standards. The quality control inquiry process is a vital complement to the peer review process.*

## **POB Oversight of the SECPS Quality Control Inquiry Process.**

The Board and its staff have unrestricted access to the QCIC process and actively participate in the consideration of each case. The staff reads all complaints submitted by member firms, SEC Accounting and Auditing Enforcement Releases against accountants, relevant financial statements and regulatory filings, and other publicly available documents on all cases considered by the QCIC.

During this past year, Board members and staff attended all meetings of the Committee and observed its deliberation of each case. Additionally, the Board's staff participated in all 52 QCIC task force meetings with member firms. In connection with these meetings, the Board's staff prepares a comprehensive report on each case for discussion with the Board.

## **QCIC Actions on Reported Cases.**

The QCIC commenced the year with 38 cases on its agenda, 48 new cases were opened during the year and 46 cases were closed.

During its initial analysis of a case, the QCIC reviews the complaints and public documents bearing on the allegations and, if applicable, SEC Accounting and Auditing Enforcement Releases. After this initial analysis, the allegations in six cases were found to be frivolous and the cases were closed without inquiry.

For the 40 cases not closed after initial analysis, QCIC task forces met with representatives of the member firms and often inspected firm guidance materials to gather information about the quality control implications emanating from the allegations.

With respect to two cases, the QCIC requested the Peer Review Committee to provide oversight in connection with the firms' upcoming peer reviews to ensure that appropriate focus is given to the quality control implications emanating from the QCIC cases. Two firms were required to engage concurring reviewers from outside their firms to perform preissuance reviews of accountants' reports, financial statements and workpapers for their SEC engagements.

One firm agreed to monitor the work of certain individuals and another firm agreed to review engagements with characteristics similar to those involved in the case addressed by the QCIC. One firm agreed to revise its quality control policies and procedures with respect to monitoring certain potential independence issues.

The QCIC noticed an apparent pattern of aggressive accounting on several cases involving one firm. All of these cases involved situations where that firm's technical specialists were consulted and concurred with the accounting. The QCIC discussed with senior management of the firm its concern that the firm's consultants too readily accepted the clients' accounting for certain transactions, events and changed circumstances. Management of the firm took appropriate action to remedy the situation.

## **Communications with Standard Setters.**

During its analysis of cases, the QCIC is cognizant of the need to identify matters that it believes the profession would benefit from additional or more specific standards or guidance.

The Committee identified three such areas during the past year. One results from the QCIC's observation that in a number of cases, particularly in high tech industries, "side agreements" were entered into by client marketing personnel frequently without the knowledge of senior management or the outside auditors. These side agreements often result in revenue being inappropriately recorded because customers are, for example, given extended rights of return and/or pricing protection. The QCIC has requested that the Auditing Standards Board consider the issuance of guidance for auditors in situations where confirming

sales terms with key sales personnel would be appropriate.

The second matter involves stock ownership and other relationship issues proscribed by independence rules. The issue was referred to the Independence Standards Board for its consideration in developing guidance for the profession.

The third matter involves the QCIC's observation of the propriety of disclosure concerning whether related party transactions were equivalent to "arms-length." The QCIC has requested the Auditing Standards Board and the Emerging Issues Task Force to consider the issue.

#### SEC Access to the QCIC Process.

The SEC has reviewed the results of the QCIC process. In connection with each case, the QCIC's staff prepares a comprehensive summary supporting its work which addresses each significant

allegation together with the respective inquiry and other procedures performed. Any corrective actions taken by a firm in connection with the case are also included in the summary together with the basis for the QCIC's conclusion. In addition, the SEC also has reviewed the POB's files which include comprehensive memoranda documenting its oversight of inquiry and other procedures performed by the QCIC task forces.

#### Re-evaluation Task Force.

During early 1999, the QCIC formed a Re-evaluation Task Force to review the QCIC's objectives, organization and operations. In addition to reviewing the QCIC's organizational and operating documents, the Task Force interviewed various constituents to obtain their perceptions of the QCIC. Those interviewed included representatives from eight member firms (the Big 5, two national firms and one regional firm),

certain members of the SECPS Executive Committee and Peer Review Committee, and staff of the POB's Panel on Audit Effectiveness. Staff of the POB participated in the work of the Task Force.

The Task Force made several recommendations that it believes will improve the QCIC process. The Board concurs in this assessment. The major recommendations, all of which were approved by the SECPS Executive Committee, include the following:

- *Establishment of a QCIC Database* – In response to comments that the QCIC should provide guidance to the profession from what it learns through its inquiry process, the QCIC will maintain a masked database (to assure confidentiality) that will include information to facilitate the identification of trends that require consideration of the need for profession-wide guidance and standards.
- *Establishment of a Timetable for the Processing of Cases* – To enhance the timeliness of processing cases in order to accelerate the implementation of corrective actions when necessary.
- *Strengthening the Relationship between the QCIC and the SECPS Peer Review Committee* – To improve the effectiveness of QCIC as a complement to the peer review process, the QCIC and the PRC agreed that a representative from each committee will attend the other committee's meetings. Additionally, prior to the commencement of each annual peer review cycle, the QCIC will advise the PRC of major issues arising during the year from the QCIC process that should be considered in connection with the upcoming cycle of peer reviews.

TABLE V – QCIC ACTIVITY

	Inception through 6/30/98	12 Months ended 6/30/99	Totals
<b>Actions Related to Firms</b>			
Either a special review was made, the firm's regularly scheduled peer review was expanded, or other relevant work was inspected	70	2	72
A firm took appropriate corrective measures that were responsive to the implications of the specific case	127	6	133
<b>Actions Related to Standards</b>			
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards	46	3	49
The Professional Issues Task Force was asked to consider the issuance of a practice alert	21	2	23
<b>Actions Related to Individuals</b>			
The case was referred to the AICPA Professional Ethics Executive Committee with a recommendation for investigation into the work of specific individuals	32	14	46
	296	27	323
(Note: Frequently more than one action is taken by the QCIC or by the firm on an individual case.)			

### **Memorandum of Understanding with the AICPA Professional Ethics Division.**

Under the bylaws of the AICPA, the Professional Ethics Executive Committee (PEEC) has the responsibility, among other things, to enforce the Code of Professional Conduct. Only PEEC has jurisdiction over individual members of the AICPA with respect to the Code of Professional Conduct and interpretations and rulings thereof.

During the preceding year, the QCIC and the PEEC developed a Memorandum of Understanding to avoid, where possible, the duplication of efforts between the two self-regulatory committees and to streamline PEEC's process.

After each case is closed by the QCIC, a review panel assigned by the PEEC reviews the case summary prepared by the QCIC staff. While the role of the QCIC is not to determine if performance of individual members of the AICPA was substandard, its analysis of cases and the results of its inquiry often enable a determination that the allegations are frivolous or that it is likely that generally accepted auditing standards were adhered to. Such determinations, when made known to the PEEC through the closed case summary, may enable it to conclude it need not open a file on individuals involved in the alleged audit failure. This has resulted in more effective utilization of both PEEC's and the member firms' resources.

### **Referrals of Individuals to the AICPA Professional Ethics Division.**

During the past year the QCIC referred the engagement partners from member firms involved in fourteen cases to the PEEC for it to determine whether performance was substandard.

The QCIC occasionally becomes aware of CPAs employed by companies audited by member firms who warrant investigation. Three CPAs employed as CFOs and one CPA serving as a CEO were referred to the PEEC for its consideration. These four individuals, who were employed by four different SEC registrants, were allegedly involved in fraudulent financial reporting.

### **Summary and Conclusions.**

It is the Board's belief that the QCIC process is functioning as designed and is effective in identifying litigation matters that lead to (a) improvement in quality control systems of firms involved in litigation, and (b) enhanced profession-wide audit guidance.

The Board also believes that the recently implemented recommendations of the Re-evaluation Task Force will enhance the effectiveness of the QCIC process, particularly the establishment and maintenance of a QCIC database.

In its 1998 Annual Report to Congress, the SEC reported that "the peer review and QCIC processes continue to result in member firms focusing on and achieving the important goal of maintaining and improving effective quality control systems."

## **The John J. McCloy Award**

This year the POB selected Ralph S. Saul as the recipient of the 1999 John J. McCloy Award for outstanding contributions to the auditing profession in the U.S.

In selecting Mr. Saul, the Board selected a non-accountant who recognizes the importance of independent auditing to the U.S. capital markets. He has devoted his energy and intellect over the years to enriching the professionalism of auditors and improving auditor performance, and he continues to do so. Mr. Saul is presently a member of the POB's Panel on Audit Effectiveness. He previously was a member of the AICPA Board of Directors. He was a member of the POB's 1994 Advisory Panel on Auditor Independence, devoting six months to studying the issues then affecting professionalism and formulating recommendations to increase the value of the independent audit.

Mr. Saul's career includes serving as director of the SEC's Division of Trading and Markets and associate director of the SEC's Special Study of Security Markets. He was president of the American Stock Exchange and CEO and chairman of CIGNA Corp.

# About the SEC Practice Section and the Public Oversight Board

## **SECPS**

The SEC Practice Section was founded in 1977 as part of the Division for CPA Firms of the American Institute of Certified Public Accountants and is overseen by the Public Oversight Board. The Section imposes membership requirements and administers two programs to help insure that SEC registrants are audited by member firms with effective quality control systems. The first is peer review, a process to review the practices of Section members every three years by other accountants. The other major program is quality control inquiry, which reviews allegations of audit failure contained in litigation filed against member firms involving SEC clients.

## **Membership in the SECPS**

About 1,300 firms belong to the SECPS including virtually all accounting firms that audit publicly held companies. The requirements of the SECPS affect more than 127,000 professionals at member firms that audit more than 15,600 SEC clients.

Member firms of the SECPS must adhere to quality control standards established by the AICPA; have a peer review every three years, the results of which are maintained in a public file; and report to the SECPS Quality Control Inquiry Committee litigation against the firm that alleges deficiencies in the audit of a SEC client and regulated financial institution. Among other membership requirements, firms must periodically rotate the partner in charge of each SEC audit engagement and conduct a concurring, or second partner, preissuance review of each SEC audit engagement.

## **The Public Oversight Board**

An independent private sector body, the Public Oversight Board was created in 1977 for the purpose of overseeing and reporting on the self-regulatory programs of the SEC Practice Section of the AICPA. The POB is responsible for monitoring and commenting on matters that affect public confidence in the integrity of the audit process. Funded by dues paid by SECPS members, the Board's independence is assured by its power to appoint its own members, chairperson and staff, set its own budget and establish its own operating procedures. The Board consists of five members, primarily non-accountants, with a broad spectrum of business, professional, regulatory and legislative experience.



## MEMBERS OF THE PUBLIC OVERSIGHT BOARD

### **CHARLES A. BOWSHER**

Chairman, 1999 – present; joined Board in 1997; Comptroller General of the United States and head of the General Accounting Office, 1981-1996; Partner of Arthur Andersen & Co., 1971-1981; Assistant Secretary of the Navy-Financial Management, 1967-1971; presently a director of several public companies

### **DONALD J. KIRK**

Vice Chairman, 1999 – present; joined Board in 1995; Financial Accounting Standards Board, member 1973-1977, Chairman 1978-1986; Partner of Price Waterhouse & Co., 1967-1973; Columbia Business School, Professor 1987-1994, Executive-in-Residence, 1995-present; presently a director of several public companies

### **ROBERT F. FROEHLKE**

Joined Board in 1987; President and CEO of IDS Mutual Fund Group, 1987-1993; Chairman of the Board of Equitable Life Assurance Society, 1982-1987; Secretary of the Army, 1971-1973

### **MELVIN R. LAIRD**

Joined Board in 1984 and served as Vice Chairman from 1997-1999; Counsellor to the President, 1973-1974; Secretary of Defense, 1969-1973; nine-term U.S. Congressman, 1953-1969; Senior Counselor for National and International Affairs, The Readers Digest Association, Inc.

### **A. A. SOMMER, JR.**

Joined Board in 1983 and served as Chairman from 1986-1999; SEC Commissioner, 1973-1976; retired Partner and presently of Counsel to Washington, DC law firm of Morgan, Lewis & Bockius specializing in securities law

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